

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the consolidated financial condition and results of operations of EXFO Electro-Optical Engineering Inc. for the fiscal years ended August 31, 2003, 2004 and 2005, should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report. Our consolidated financial statements are reported in US dollars and have been prepared in accordance with generally accepted accounting principles in Canada, or Canadian GAAP. Significant differences in measurement and disclosure from generally accepted accounting principles in the United States, or U.S. GAAP, are set out in note 21 to our consolidated financial statements.

The following discussion and analysis of financial condition and results of operations is dated November 3, 2005.

Industry Overview

Leading telecom operators (telcos), mostly in the United States, accelerated fiber deployments deeper in their access networks during the last year because they are involved in a triple-play war (even quadruple-play with wireless telephony) against cable TV operators (cablecos) to offer consumers bundled voice, data and video services. This broadband war between telcos and cablecos contributed to an increase in wireline capital expenditures in 2005, especially in the United States.

Leading US telcos, along with a number of Tier-II and Tier-III players, opted for an assortment of deployment strategies, including fiber-to-the-node (FTTN), fiber-to-the-curb (FTTC), fiber-to-the-home (FTTH) or its equivalent fiber-to-the-premises (FTTP), depending on the bets they placed in terms of how much bandwidth will be required to meet the challenge from the cablecos. These deployments, which fall under the generic FTTx name, are not as prevalent in Europe and Asia. However, test trials are underway in these regions as a means to increase revenues by delivering video services to undercut competition. Note that Japan and Korea already have FTTx deployment programs, aimed at delivering 100 Mb/s to every home, well underway.

As the demand for broadband services increases worldwide, voice, data and video are becoming mere applications on converged, IP-based networks. Telcos around the world are migrating from public switched telephone networks (PSTN) to packet-based, IP networks in order to achieve substantial reductions in operating expenses and increased profitability. British Telecom Group, for example, announced it will spend £10 billion over five years on its 21st Century Network to reduce operating expenses by up to £1.0 billion per year through a single network carrying voice, data and video signals.

Legacy SONET/SDH networks were designed in the late 1970s to carry voice traffic. Their efficiency however can often times drop to as low as 30% when combining voice, data and video services. Next-generation networks, such as those announced by British Telecom, represent a major technological improvement, since they can deliver triple-play services at near 100% efficiency, regardless of the payload content, while significantly reducing the cost of operating and maintaining networks.

These key market trends affected multiple segments of the global telecommunications supply chain in 2005. System manufacturers benefited from orders by both telcos and cablecos for next-generation, converged IP networks as well as from major investments by telcos in access networks. Component vendors saw incremental demand for optical components that support FTTx and IP-based systems. Some test and measurement equipment vendors attracted the attention of telcos, cablecos, system manufacturers and component vendors, especially ones offering test solutions for IP optical networking and/or FTTx applications.

Company Overview

EXFO is a recognized expert in the global telecommunications industry through the design and manufacture of advanced and innovative test and measurement solutions. The Telecom Division, which represents our main business activity, offers a complete range of dedicated and integrated test solutions to network service providers (NSPs), cable operators, system vendors and component manufacturers in approximately 70 countries. One of our strongest competitive advantages is our modular test platform design – based on a PC/Windows-centric architecture – which offers a series of test modules that maximize technology reuse across multiple market segments at minimal cost. The Life Sciences and Industrial Division, formerly called Photonics and Life Sciences Division, mainly leverages core telecom technologies to offer value-added solutions for life sciences applications and high-precision assembly processes, such as those required for microelectronics and optoelectronics.

This year marked EXFO's 20th anniversary, as the company was founded in 1985 in Quebec City, Canada. Our original products were focused on the needs of installers and operators of fiber-optic networks. Customers use these field-portable testing products for the installation, maintenance, monitoring and troubleshooting of optical networks. In 1996, we supplemented our product portfolio with an extensive line of high-end products that are mainly dedicated to research and development as well as manufacturing activities of optical component manufacturers and system vendors.

In the last four years, we have enhanced our competitive position through the acquisition of two protocol test businesses in order to expand our product offering and address our customers' requirements more completely. In November 2001, we acquired Avantas Networks Corporation (renamed EXFO Protocol Inc.), a supplier of protocol-testing and optical-network performance-management equipment for NSPs. This transaction was highly strategic because it enabled us to combine optical and protocol test modules inside a single field-portable test platform to help our customers increase revenues and reduce operating costs. In October 2002, our wholly-owned subsidiary, EXFO Gnubi, purchased substantially all the assets of *gnubi communications, L.P.*, a supplier of multi-channel telecom and datacom testing solutions for the system manufacturer market. These strategic acquisitions, which were consolidated in Montreal in fiscal 2004, enabled us to more than double our addressable market, as we expanded from optical testing to protocol testing applications, and to offer a more complete line of test solutions to our customers.

Previously, we had completed two acquisitions to bolster growth in the optical component manufacturing market. We acquired Burleigh Instruments, Inc. (renamed EXFO Burleigh Products Group Inc.) in December 2000 for its wavelength measurement instruments and nanopositioning alignment systems. We also added EFOS Inc. (renamed EXFO Photonic Solutions Inc.) in March 2001 for its precision light-based, adhesive spot-curing technology. We have since exited the optical component manufacturing automation business.

In fiscal 2005, we launched 15 new products, including a next-generation SONET/SDH analyzer for characterizing converged, IP-based networks; a 10 Gigabit Ethernet (GigE) test solution to assess quality of service in core and metro networks; a new software suite for remote Ethernet testing and commissioning applications; an all-band component analyzer for FTTx and coarse wavelength-division multiplexing (CWDM) applications in the manufacturing/research and development market; a series of three handheld test instruments for the installation and maintenance market; and an optical spectrum analyzer (OSA) for CWDM applications in metro and access networks. In addition, we formed an alliance with ADC Telecom to provide a unique remote Ethernet test solution for first-mile applications.

In 2005, we also consolidated our leadership position in the FTTx test market by recognizing significant revenue from two leading U.S. carriers deploying fiber in their access networks. Our top customer accounted for 23.3% of sales in 2005. Subsequent to the year-end, we were selected as sole-source supplier for all fiber deployment test applications by Deutsche Telekom AG – including FTTx.

We recorded a foreign exchange loss of \$1.3 million in fiscal 2005 due to the significant increase in the value of the Canadian dollar versus the US dollar during that year. In addition to this foreign exchange loss, our P&L (profits and losses) line items in 2005 were also negatively affected by the appreciation of the Canadian dollar, since a significant portion of our expenses are incurred in Canadian dollars while we report our results in US dollars.

In the third quarter of fiscal 2005, EXFO was named recipient of the 2005 Growth Strategy Leadership Award by Frost & Sullivan, a leading market research firm in the telecommunications test sector. The award is presented annually to the company whose visionary growth strategy generates the largest market-share gains in the global fiber-optic test equipment market in the previous year. Based on a report by Frost & Sullivan, we increased our market share from 8.4% in fiscal 2003 to 10.3% in 2004. This marked the second consecutive year that we earned this industry award.

Finally, during fiscal 2005, we completed the consolidation of our Life Sciences and Industrial Division in Toronto and we recorded \$482,000 in restructuring expenses. Altogether, we incurred \$2.5 million in restructuring and other charges since the fourth quarter of 2004 in conjunction with this consolidation process.

Sales

We sell our products to a diversified customer base in approximately 70 countries through our direct sales force and, indirectly, through distribution channels. Most of our sales are denominated in US dollars and Euros.

Historically, it has been very unusual to have any customer account for more than 10% of our sales. However, in both fiscal 2004 and 2005, we had one customer that accounted for 13.8% and 23.3% of our sales, respectively. In fiscal 2005, our top three customers accounted for 28.4%, compared to 20.8% in 2004. We believe the sales concentration in fiscal 2005 is largely due to our leadership position in the FTTx test market, as a large portion of our sales to our top customer was for a series of products related to FTTx deployment. We expect this sales concentration to decrease in fiscal 2006, as we continue efforts to diversify our customer base.

Despite the fact that we had one customer that accounted for a substantial part of our sales in fiscal 2005, we believe that we have a vast array of products and a diversified customer base, both in terms of industry sector and geographical area, which provides us with reasonable protection against concentration of sales and credit risk.

Cost of Sales

Cost of sales includes raw materials, salaries and related expenses for direct and indirect manufacturing personnel (net of government grants) as well as overhead costs. Excess, obsolete and scrapped materials are also included in cost of sales. However, cost of sales is exclusive of amortization, which is shown separately in the statements of earnings.

Operating Expenses

We classify our operating expenses into three main categories: selling and administrative expenses, research and development expenses and amortization expenses.

Selling and administrative expenses consist primarily of salaries and related expenses for personnel (net of government grants), sales commissions, travel expenses, marketing programs, professional services, information systems, human resources and other corporate expenses.

Gross research and development expenses consist primarily of salaries and related expenses for engineers and other technical personnel, material component costs as well as fees paid to third-party consultants. We are eligible to receive research and development tax credits and government grants on research and development activities carried out in Canada. All related research and development tax credits and government grants are recorded as a reduction of gross research and development expenses. Tax credit write-offs are also included in net research and development expenses.

Operating charges related to our restructuring plans have been recorded as a separate component of operating expenses. These charges consist primarily of severance expenses, costs to exit leased facilities as well as write-offs of long-lived assets.

Our Strategy

Strategic Objectives for Fiscal 2005

In our fiscal 2004 Annual Report, we had established three strategic objectives for fiscal 2005. We planned to increase sales through market-share gains, maximize profitability and focus on innovation. The following section reviews our strategic objectives for fiscal 2005 and the results achieved for each of these objectives.

Increase sales through market-share gains

In fiscal 2005, we focused on continued market-share gains to achieve growth. We posted our second-best sales performance in history, growing sales 30.3% to \$97.2 million in fiscal 2005, compared to a stated goal of 20%. Considering that the telecommunications market slightly improved in fiscal 2005, this is a clear indication that we gained market share overall. For fiscal 2005, our Telecom Division and our Life Sciences and Industrial Division reported sales increases of 36.1% and 8.6%, respectively.

Maximize profitability

Returning to profitability remains a top priority at EXFO. In fiscal 2005, we substantially reduced our loss from operations from \$10.6 million in fiscal 2004 to \$199,000 in 2005. The loss from operations incurred in fiscal 2005 includes restructuring and other charges of \$292,000, recorded in conjunction with the consolidation of the operations of our Life Sciences and Industrial Division and stock-based compensation costs of \$963,000.

Focus on innovation

In fiscal 2005, innovation was a key driver at EXFO. We maintained a significant level of research and development investments and introduced 15 new products to the marketplace. We invested \$15.9 million in gross research and development expenses, an amount similar to 2004. In fiscal 2005, 42.4% of our sales originated from products that have been on the market for two years or less, which is slightly below our stated goal of 45% for fiscal 2005. While we slightly missed our target, this represents a significant improvement over the prior year (31.7%), thanks to the 20 new products brought to the marketplace in fiscal 2004 – several of which were released in the second half of the fiscal year – and the 15 new ones launched in fiscal 2005.

Strategic Objectives for Fiscal 2006

For fiscal 2006, we believe general market conditions will moderately improve as carriers around the world intensify triple-play investments in an effort to bolster revenues and/or provide a defensive/offensive measure in the telcos vs. cablecos battle to deliver video, data and voice services to residential and business customers. This ongoing trend will prompt increased capital expenditures (CAPEX) mainly in the access network market, likely over several years to come. On a more global basis, the migration of these services onto a single, IP-based network to reduce operating expenditures will instigate increased CAPEX in the network core. On the strength of our market-driven research and development program, we are well-positioned for these latest industry trends.

As one might expect, our strategic directions, and therefore our key performance indicators, will not be radically different from those of 2005. Since we are highly focused on creating value for our shareholders, providing the highest degree of profitable growth is at the heart of our actions. We intend to maintain our long-term focus on profitable growth by increasing sales through further market-share gains; maximize profitability through proper execution and efficiency of our cost-reduction programs; and focus on innovation to positively position the organization for the long-term growth opportunities that exist in our space.

Increase sales through market-share gains

In fiscal 2006, we will continue focusing on market-share gains and growing faster than our end markets. In fiscal 2005, our 30.3% sales growth in a slightly increasing market clearly indicated that we gained market share. As mentioned earlier, EXFO was named recipient of the 2005 Growth Strategy Leadership Award by Frost & Sullivan. The award is presented annually to the company whose visionary growth strategy generates the largest market-share gains in the global fiber-optic test equipment market in the previous year. Based on Frost & Sullivan, we increased our market share from 8.4% in fiscal 2003 to 10.3% in 2004. For fiscal 2006, we intend once again to grow sales faster than the market by leveraging our sustained research and development investments in areas such as next-generation Internet protocol (IP) and FTTx testing, by intensifying our sales and marketing efforts, both domestic and international, as well as by strengthening and expanding our business relationships with major accounts.

Maximize profitability

Profitability remains a top priority and we expect that sales growth combined with a strong focus on operations will increase our earnings from operations in fiscal 2006, assuming no acquisitions.

Focus on innovation

In fiscal 2006, innovation will continue to be a major growth vehicle for us, as it significantly drives not only revenue and profitability, but also allows us to better position ourselves in the long term. We remain convinced that our commitment to innovation will pay off in the long term and support our growth and profitability targets as demonstrated during the last fiscal year. We have maintained a significant level of research and development investments since the telecom peak in 2001 and brought 15 new products to the marketplace in fiscal 2005. Now that our net research and development investments as a percentage of sales are in line with our long-term model, we intend, for fiscal 2006 and beyond, to increase our investment in research and development activities in proportion to our sales growth. Our numerous but focused research and development initiatives should enable our new products to continue gaining traction with customers and lead to further growth, market-share gains and increased profitability in the coming years.

Key Performance Indicators

As measures to assess the realization of our strategic plan and its objectives, we have set out three consolidated key performance indicators for fiscal 2006.

They are summarized as follows:

Strategic objectives for fiscal 2006	Key performance indicators for fiscal 2006
Increase sales through market-share gains	15% sales growth year-over-year
Maximize profitability	5% in earnings from operations
Focus on innovation	40% of sales from new products (on the market two years or less)

Capability to Deliver Results

At EXFO, we believe that we have the capabilities to deliver expected results thanks to outstanding products, an excellent reputation in the marketplace, a sound financial position, as well as an experienced workforce and management team.

Critical Accounting Policies and Estimates

Management’s discussion and analysis of financial conditions and results of operations is based on our consolidated financial statements included elsewhere in this Annual Report. As previously mentioned, they have been prepared in accordance with Canadian GAAP. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting years. On an ongoing basis, we evaluate these estimates and assumptions, including those related to revenue recognition, allowance for doubtful accounts, allowance for excess and obsolete inventories, research and development tax credits and government grants, impairment of long-lived assets and goodwill, valuation allowance of future income tax assets, warranty obligations, restructuring charges, contingencies and other obligations as well as stock-based compensation costs. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates.

The following summarizes our critical accounting policies as well as other policies that require the most significant judgment and estimates in the preparation of our consolidated financial statements.

Revenue recognition. For products in which software is incidental, we recognize revenue when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed and determinable and collection of the resulting receivable is reasonably assured. In addition, provisions are made for estimated returns, warranties and support obligations.

For products in which software is not incidental, revenues are separated into two categories: product and post-contract customer support (PCS) revenues, based upon vendor-specific objective evidence of fair value. Product revenues for these sales are recognized as described above. PCS revenues are deferred and recognized ratably over the years of the support arrangement.

PCS revenues are recognized at the time the product is delivered when provided within one year of delivery; the costs of providing this support are insignificant (and accrued at the time of delivery) and no software upgrades are provided.

For all sales, we use a binding purchase order as evidence that a sales arrangement exists.

Delivery generally occurs when the product is handed over to a transporter for shipment.

At the time of the transaction, we assess whether the price associated with our revenue transaction is fixed and determinable, and whether or not collection is reasonably assured. We assess whether the price is fixed and determinable based on the payment terms associated with the transaction. We assess collection based on a number of factors, including past transaction history and the creditworthiness of the customer. Generally, collateral or other security is not requested from customers.

Most sales arrangements do not generally include acceptance clauses. However, if a sales arrangement does include an acceptance provision, acceptance occurs upon the earliest of the receipt of a written customer acceptance or the expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

Revenue for extended warranties is recognized on a straight-line basis over the warranty period.

Allowance for doubtful accounts. We estimate collectibility of accounts receivable on an ongoing basis by reviewing balances outstanding over a certain period of time. We determine our allowance for doubtful accounts receivable based on our historical accounts receivable collection experience and on the information that we have about the status of our accounts receivable balances. If the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make required payments, additional allowance may be required, which could adversely affect our future results.

Allowance for excess and obsolete inventories. We state our inventories at the lower of cost, determined on an average cost basis and replacement cost or net realizable value, and provide reserves for excess and obsolete inventories. We determine our reserves for excess and obsolete inventories based on the quantities we have on hand versus expected needs for these inventories, so as to support future sales of our products. It is possible that additional inventory reserves may occur if future sales are less than our forecasts or if there is a significant shift in product mix compared to our forecasts, which could adversely affect our future results.

Research and development tax credits and government grants. We record research and development tax credits and government grants based on our interpretation of tax laws and grant programs, especially regarding related eligible projects and expenses, and when there is reasonable assurance that we have complied and will continue to comply with all conditions and laws. Also, our judgment and estimates are based on historical experience. It is possible, however, that the tax authorities or the sponsors of the grant programs have a different interpretation of laws and application of conditions related to the programs or that we do not comply with all conditions related to grants in the future, which could adversely affect our future results. Furthermore, a significant part of our tax credits are refundable against income taxes payable, causing their ultimate realization to be dependent upon the generation of taxable income. If we obtain information that causes our forecast of future taxable income to change or if actual taxable income differs from our forecast, we may have to revise the carrying value of these tax credits, which would affect our results in the period in which the change was made. We review the recoverability of such tax credits on a quarterly basis.

Impairment of long-lived assets and goodwill. We assess impairment of goodwill on an annual basis, or more frequently, if events or circumstances indicate that it might be impaired. Recoverability of goodwill is determined at the reporting unit level using a two-step approach. First, the carrying value of a reporting unit is compared to its fair value, which is determined based on a combination of discounted future cash flows and a market approach. If the carrying value of a reporting unit exceeds its fair value, the second step is performed. In this step, the amount of impairment loss, if any, represents the excess of the carrying value of goodwill over its fair value and the loss is charged to earnings in the period in which it is incurred. For the purposes of this impairment test, the fair value of goodwill is estimated in the same way as goodwill is determined in business combinations; that is, the excess of the fair value of a reporting unit over the estimated fair value of its net identifiable assets.

We assess impairment of long-lived assets when events or circumstances indicate that costs may not be recoverable. Impairment exists when the carrying value of an asset, or a group of assets, is greater than the pre-tax undiscounted future cash flows expected to be provided by the asset or the group of assets. The amount of impairment loss, if any, is the excess of the carrying value over the fair value. We assess fair value of long-lived assets based on discounted future cash flows.

Future income taxes. We account for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities, using enacted income tax rates for the years in which the differences are expected to reverse. In assessing the recoverability of our future income tax assets, we consider whether it is more likely than not that some or all of the future income tax assets will not be realized. The ultimate realization of our future income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences will become deductible. As at August 31, 2005, we had established a full valuation allowance against our future income tax assets.

The valuation allowance will be reversed once management will have concluded that realization of future income tax assets is more likely than not.

Stock-based compensation costs. Since September 1, 2003, we account for all forms of employee stock-based compensation using the fair value-based method. This method requires that we make estimates about the risk-free interest rate, the expected volatility of our shares and the expected life of the awards.

On September 1, 2004, we prospectively adopted the following new Canadian Institute of Chartered Accountants (CICA) handbook sections:

- Section 1100, "Generally Accepted Accounting Principles"
- Section 1400, "General Standards of Financial Statement Presentation"

Furthermore, in January 2005, the CICA issued four new accounting standards in relation to financial instruments: Section 3855, "Financial Instruments – Recognition and measurement"; Section 3865, "Hedges"; Section 1530, "Comprehensive Income"; and Section 3251, "Equity". These new standards apply to fiscal years beginning on or after October 1, 2006, and we will adopt them on September 1, 2007.

Please refer to note 2 to our consolidated financial statements included elsewhere in this Annual Report for further information about these new standards and their impact on our financial statements.

Results of Operations

The following table sets forth certain Canadian GAAP consolidated financial statements data in thousands of US dollars, except per share data, and as a percentage of sales for the years indicated:

Consolidated statements of earnings data:	2005	2004	2003	2005	2004	2003
Sales	\$ 97,216	\$ 74,630	\$ 61,930	100.0%	100.0%	100.0%
Cost of sales ⁽¹⁾	44,059	34,556	36,197	45.3	46.3	58.4
Gross margin	53,157	40,074	25,733	54.7	53.7	41.6
Operating expenses						
Selling and administrative	31,782	25,890	26,991	32.7	34.7	43.6
Net research and development	12,190	12,390	15,879	12.5	16.6	25.6
Amortization of property, plant and equipment	4,256	4,935	5,210	4.4	6.6	8.4
Amortization of intangible assets	4,836	5,080	5,676	5.0	6.8	9.2
Impairment of long-lived assets and goodwill	-	620	7,427	-	0.8	12.0
Restructuring and other charges	292	1,729	4,134	0.3	2.3	6.7
Total operating expenses	53,356	50,644	65,317	54.9	67.8	105.5
Loss from operations	(199)	(10,570)	(39,584)	(0.2)	(14.1)	(63.9)
Interest and other income	2,524	1,438	1,245	2.6	1.9	2.0
Foreign exchange loss	(1,336)	(278)	(1,552)	(1.4)	(0.4)	(2.5)
Earnings (loss) before income taxes	989	(9,410)	(39,891)	1.0	(12.6)	(64.4)
Income taxes	2,623	(986)	15,059	2.7	(1.3)	24.3
Net loss for the year	\$ (1,634)	\$ (8,424)	\$ (54,950)	(1.7)%	(11.3)%	(88.7)%
Basic and diluted net loss per share	\$ (0.02)	\$ (0.13)	\$ (0.87)			
Segment information						
Sales:						
Telecom Division	\$ 80,120	\$ 58,882	\$ 48,753	82.4%	78.9%	78.7%
Life Sciences and Industrial Division	17,096	15,748	13,177	17.6%	21.1%	21.3%
	\$ 97,216	\$ 74,630	\$ 61,930	100.0%	100.0%	100.0%
Operating earnings (loss): ⁽²⁾						
Telecom Division	\$ 763	\$ (5,557)	\$ -	0.8%	(7.4)%	-%
Life Sciences and Industrial Division	(962)	(5,013)	-	(1.0)	(6.7)	-
	\$ (199)	\$ (10,570)	\$ -	(0.2)%	(14.1)%	-%
Research and development data:						
Gross research and development	\$ 15,878	\$ 15,668	\$ 17,133	16.3%	21.0%	27.7%
Net research and development	\$ 12,190	\$ 12,390	\$ 15,879	12.5%	16.6%	25.6%
Consolidated balance sheets data:						
Total assets	\$ 190,957	\$ 172,791	\$ 146,254			

(1) The cost of sales is exclusive of amortization, shown separately. Including inventory write-offs of \$4,121,000 and an unusual gain of \$473,000 for the year ended August 31, 2003.

(2) Comparative information for fiscal 2003 for the loss from operations is not available and is impracticable to determine.

Sales

Fiscal 2005 vs. 2004

In fiscal 2005, our global sales increased 30.3% to \$97.2 million from \$74.6 million in 2004, with an 82%-18% split in favor of our Telecom Division.

Telecom Division

In fiscal 2005, sales of our Telecom Division increased 36.1% to \$80.1 million from \$58.9 million in 2004. Since the second half of fiscal 2004, we have benefited from an increased demand for our test solutions following the deployment of fiber deeper into access networks (FTTx). In fiscal 2005, we consolidated our leadership position in the FTTx test market by recognizing significant revenue from two leading U.S. carriers deploying fiber in their access networks. Our largest customer, who purchased several orders of FTTx test equipment, accounted for 28.2% of telecom sales in fiscal 2005 (17.5% in 2004). In addition, the positive spending environment helped us increase our sales in 2005.

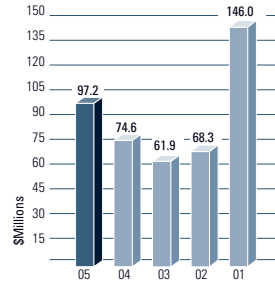
Although sales of our protocol test products increased sequentially each quarter in fiscal 2005 and reached more than 10% of Telecom revenues in the fourth quarter of 2005, they still fell below 10% for the whole fiscal year. Our penetration of the protocol test market has been modest since, in 2003, we refocused our efforts onto next-generation solutions, which are at the basis of the whole trend toward IP convergence. We expect that protocol sales will equal optical sales on a medium- to long-term basis given that the protocol test market is more than double the size of the optical test market, our rich product pipeline in protocol testing, and increasing customer traction. We remain confident that the solid product portfolio we are building for this crucial end-market will lead to long-term growth for EXFO.

Life Sciences and Industrial Division

In fiscal 2005, sales of our Life Sciences and Industrial Division increased 8.6% to \$17.1 million from \$15.7 million in 2004. The increase in sales in fiscal 2005, compared to 2004, is mainly due to market-share gains in the fluorescence illumination market as well as increased sales activities in the curing market.

Overall, for the two divisions, net accepted orders increased 35.6% to \$101.7 million in fiscal 2005 from \$75.0 million in 2004. Our net book-to-bill ratio rose to 1.05 in fiscal 2005, from 1.00 in 2004. The increased demand for our test solutions for FTTx applications, market-share gains in the telecommunications and life sciences markets, as well as the slight improvement in the telecommunications market environment helped us increase our bookings year-over-year.

For the upcoming quarters, we expect the sales split between the two divisions to remain in the same range as for fiscal 2005.



Fiscal 2004 vs. 2003

In fiscal 2004, our global sales increased 20.5% to \$74.6 million from \$61.9 million in 2003, with a 79%-21% split in favor of our Telecom Division.

Telecom Division

In fiscal 2004, sales of our Telecom Division increased 20.8% to \$58.9 million from \$48.8 million in 2003. In 2004, despite a relatively stable carrier spending environment compared to the previous year, we continued to gain market share, which helped us increase our sales year-over-year. We believe these market-share gains are mainly attributable to our optical field-testing products, which represent our traditional core business, since sales of our protocol-layer test solutions represented just over 10% of our Telecom sales in fiscal 2004. In addition, we benefited from a slight recovery in the telecom system and optical manufacturing markets. Finally, revenues from FTTx test solutions were higher than expected, especially with a leading U.S. carrier, which contributed to our sales increase.

Life Sciences and Industrial Division

In fiscal 2004, sales of our Life Sciences and Industrial Division increased 19.5% to \$15.7 million from \$13.2 million in 2003. The increase in sales is due to the greater demand for our high-precision assembly solutions.

Geographic Distribution

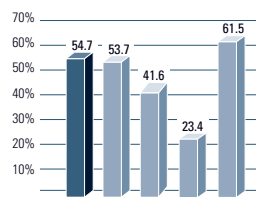
During fiscal 2005, sales to the Americas, Europe-Middle East-Africa (EMEA) and Asia-Pacific (APAC) accounted for 68%, 20% and 12% of global sales, respectively. Our sales to the Americas, which increased 34% year-over-year, benefited from the recent deployments of fiber deeper in access networks (mainly in the United States). Our sales to EMEA increased more significantly (42%) year-over-year, mainly due to market-share gains in both divisions, following our efforts to develop this important end-market. Finally, our sales to APAC remained flat in dollars year-over-year. A significant portion of our sales to this region of the world are made through price-driven tenders that may vary in number and importance from quarter to quarter. Also, the competitive landscape in this market led to pricing pressure, which prevented us from increasing our sales year-over-year.

The geographic distribution of our sales remained unchanged as a percentage of sales in fiscal 2004, compared to 2003, since all geographic areas had the same growth level. Sales to Americas, EMEA and APAC accounted for 66%, 18% and 16% of global sales, respectively, for both fiscal years.

Through our two divisions, we sell our products to a broad range of customers, including network service providers, cable operators, optical system and component manufacturers, as well as customers in the life sciences and high-precision assembly sectors. In fiscal 2004 and 2005, one customer represented more than 10% of our sales with 13.8% of sales (\$10.3 million) in fiscal 2004 and 23.3% of sales (\$22.6 million) in 2005. During 2003, no customer accounted for more than 10% of our sales. In fiscal 2005, our top three customers accounted for 28.4% of sales, compared to 20.8% in 2004.

Gross Margin

Gross margin amounted to 54.7%, 53.7% and 41.6% of sales for fiscal 2005, 2004 and 2003, respectively.



Fiscal 2005 vs. 2004

The increase in our gross margin in fiscal 2005, compared to 2004, can be explained by the following factors. First, we were able to reduce our cost of goods sold by better leveraging our supplier base and by developing innovative new products with a cost-effective design. Also, the significant rise in sales (30.3% year-over-year) resulted in an increase in manufacturing activities, allowing us to better absorb our fixed manufacturing costs. Furthermore, streamlined operations following our consolidation actions in fiscal 2004 and 2005 and cost-reduction programs allowed us to further improve our gross margin. In addition, the shift in the geographic distribution of our sales resulted in more sales made to the Americas market, where gross margins tend to be higher because we sell direct to the customers. However, a stronger Canadian dollar, compared to the US dollar, prevented us, to some extent, from further improving our gross margin as some cost of sales elements are denominated in Canadian dollars. As well, the different customer mix and aggressive pricing pressure observed in fiscal 2005 also prevented us from further improving our gross margin.

Over the past months, we adjusted the design of some of our products and we experienced higher sales than expected. Consequently, we were able to reuse excess inventories that were written off during the telecom downturn for approximately \$1.6 million in fiscal 2005, or 1.7% of sales, compared to approximately \$600,000, or 0.8% of sales in 2004. Inventory write-offs recorded during the telecom downturn were based on management's best estimate at that time.

Fiscal 2004 vs. 2003

The increase in our gross margin in fiscal 2004, compared to 2003, can be explained by several factors. First, the rise in sales (20.5% year-over-year) helped increase our gross margin. Increased manufacturing activities allowed us to better absorb our fixed manufacturing costs. In addition, our cost-reduction measures, the consolidation of manufacturing sites and our enhanced efficiency further contributed to the increase in gross margin. However, a stronger Canadian dollar, compared to the US dollar year-over-year, prevented us, to some extent, from further improving our gross margin as some cost of sales elements are denominated in Canadian dollars. Finally, the gross margin recorded in fiscal 2003 included a charge of \$4.1 million, or 6.7% of sales, for excess and obsolete inventories and an unusual gain of \$473,000, or 0.7% of sales.

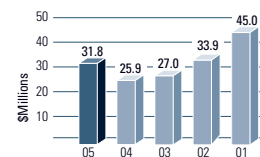
Outlook for Fiscal 2006

Considering the expected sales growth in 2006, the effect of our recent consolidation actions, the cost-effective design of our products and our tight control on operating costs, we expect our gross margin to improve in fiscal 2006. However, our gross margin may fluctuate quarter-over-quarter as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, increased obsolescence costs, shifts in product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in our

industry. Finally, a potential increase in the strength of the Canadian dollar would have a negative impact on our gross margin in 2006.

Selling and Administrative

Selling and administrative expenses were \$31.8 million, \$25.9 million and \$27.0 million for fiscal 2005, 2004 and 2003, respectively.



As a percentage of sales, selling and administrative expenses amounted to 32.7%, 34.7% and 43.6% for fiscal 2005, 2004 and 2003, respectively.

Fiscal 2005 vs. 2004

The increase in our selling and administrative expenses in dollars in fiscal 2005, compared to 2004, is mainly due to our decision to significantly increase our sales activities to better leverage the significant research and development investments of the prior years, which resulted in higher sales and marketing expenditures (including head-counts). In addition, our commission expenses increased year-over-year, especially due to the increase in sales to the Americas market. Furthermore, a stronger Canadian dollar, compared to the US dollar year-over-year, caused our selling and administrative expenses to increase, as more than half of these are incurred in Canadian dollars. Also, stock-based compensation costs were higher in fiscal 2005 (\$626,000) than in 2004 (\$265,000), further increasing our selling and administrative expenses year-over-year. Finally, costs to comply with Section 404 of the Sarbanes-Oxley Act of 2002 further increased our SG&A (selling and administrative) year-over-year. However, we were able to mitigate the increase in our selling and administrative expenses as well as reduce these expenses in percentage of sales year-over-year due to tight cost-control measures and the consolidation of our Life Sciences and industrial Division. In addition, our significant increase in revenues allowed us to reduce our selling and administrative expenses on a percentage basis.

Fiscal 2004 vs. 2003

In fiscal 2004, thanks to our restructuring actions and tight cost-control measures, we were able to reduce our selling and administrative expenses by 4% year-over-year, while our sales increased 20.5% in that same period. However, several factors prevented us from further reducing these expenses year-over-year. A higher sales volume in fiscal 2004, compared to 2003, caused our commission and marketing expenses to increase. In addition, since September 1, 2003, we account for stock-based compensation costs related to awards granted to our employees, which caused our selling and administrative expenses to increase year-over-year. Furthermore, in fiscal 2003, we recorded an unusual gain of \$239,000 related to a grant recovery. Finally, a stronger Canadian dollar, compared to the US dollar year-over-year, further increased our selling and administrative expenses, as more than half of these are incurred in Canadian dollars.

Outlook for Fiscal 2006

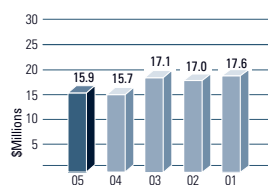
For fiscal 2006, we expect our selling and administrative expenses to increase in dollars and remain relatively stable as a percentage of sales. In particular, we expect our commission expenses to increase as sales volume increases. Also, considering our goal of becoming

the leading player in the telecom test and measurement space, we will intensify our sales and marketing efforts, both domestic and international, which will also cause our expenses to rise. Finally, a potential increase in the strength of the Canadian dollar would also cause our selling and administrative expenses to increase.

Research and Development

Gross research and development expenses

Gross research and development expenses totaled \$15.9 million, \$15.7 million and \$17.1 million for fiscal 2005, 2004 and 2003, respectively. As a percentage of sales, gross research and development expenses amounted to 16.3%, 21.0% and 27.7% for fiscal 2005, 2004 and 2003, respectively, while net research and development expenses accounted for 12.5%, 16.6% and 25.6% for these respective periods.



Fiscal 2005 vs. 2004

We incurred most of our gross research and development expenses in Canadian dollars as we have consolidated most of our research and development activities in Canada. Consequently, the significant increase in the strength of the Canadian dollar, compared to the US dollar year-over-year, caused our gross research and development expenses to increase in fiscal 2005, compared to 2004. However, this increase was mostly offset by the decrease in our gross research and development expenses in our Life Sciences and Industrial Division following the consolidation of this Division in Toronto. The decrease in our gross research and development expenses, as a percentage of sales, in fiscal 2005 compared to 2004, is directly attributable to the significant increase in sales year-over-year while these expenses remained relatively flat.

Fiscal 2004 vs. 2003

The decrease in our gross research and development expenses in fiscal 2004, compared to 2003, both in dollars and as percentage of sales, can be explained by several factors. First, our restructuring actions, the consolidation of our protocol operations in Montreal, as well as tight cost-control measures, contributed to the reduction of our gross research and development expenses year-over-year. In addition, before the end of the year, we refocused the research and development activities of our Life Sciences and Industrial Division. Finally, mix and timing of our research and development projects, especially in our Telecom Division, caused our gross research and development expenses to decrease year-over-year. On the other hand, a stronger Canadian dollar, compared to the US dollar year-over-year, increased our gross research and development expenses, as most of these are incurred in Canadian dollars.

Tax credits and grants

Tax credits and grants from the Canadian federal and provincial governments for research and development activities were \$3.7 million, \$3.3 million and \$3.6 million for fiscal 2005, 2004 and 2003, respectively.

Fiscal 2005 vs. 2004

The increase in our tax credits and grants in fiscal 2005, compared to 2004, is mainly related to the increase in our eligible gross research

and development expenses in Canada, since we were entitled to similar grant programs and tax credits year-over-year. Following the consolidation of our research and development activities in Canada, we incurred most of our research and development expenses in Canada, where we are entitled to research and development tax credits.

Fiscal 2004 vs. 2003

The decrease in our tax credits and grants in fiscal 2004, compared to 2003, is mainly related to the decrease in our eligible gross research and development expenses incurred in Canada, since we were entitled to similar tax credits year-over-year.

We still invested significantly in research and development activities in fiscal 2005 as we firmly believe that innovation and new product introductions are key in gaining market share in the current economic environment and ensuring the long-term growth and profitability of the company.

Outlook for Fiscal 2006

For fiscal 2006, we expect to increase our gross research and development expenses in proportion to our revenues, as a reflection of our focus on innovation, our desire to gain market share and our goal to exceed customer needs and expectations. Also, a potential increase in the strength of the Canadian dollar would cause our net research and development expenses to increase, as most of these are incurred in Canadian dollars.

Amortization of Property, Plant and Equipment

For fiscal 2005, amortization of property, plant and equipment was \$4.3 million, compared to \$4.9 million in 2004 and \$5.2 million in 2003. The decrease in amortization expenses in fiscal 2005, compared to 2004, despite the significant increase in the strength of the Canadian dollar compared to the US dollar, is mainly due to the fact that some of our property, plant and equipment became fully amortized during fiscal 2004.

Outlook for Fiscal 2006

For fiscal 2006, despite a potential increase in the strength of the Canadian dollar, we expect the amortization of property, plant and equipment to decrease compared to 2005 considering that some of these assets became fully amortized in 2005 or will become fully amortized in 2006.

Amortization of Intangible Assets

In conjunction with the business combinations we completed over the past few years, we recorded intangible assets, primarily consisting of core technology. These intangible assets resulted in amortization expenses of \$4.8 million, \$5.1 million and \$5.7 million for fiscal 2005, 2004 and 2003, respectively. The decrease in amortization expenses in fiscal 2005, compared to 2004, is mainly due to the fact that some of our core technologies became fully amortized during fiscal 2005.

The decrease in amortization expenses in fiscal 2004, compared to 2003, is the result of the \$2.9 million impairment charge recorded in the third quarter of fiscal 2003.

Outlook for Fiscal 2006

For fiscal 2006, we expect the amortization of intangible assets to approximate \$3.3 million, assuming no acquisitions are made during this period.

Impairment of Long-Lived Assets and Goodwill

Fiscal 2003

In May 2003, we performed our annual impairment test of goodwill for all our reporting units, except for newly acquired EXFO Gnubi. Also, considering market conditions in the telecommunications industry and the persisting unfavorable conditions affecting our subsidiaries' industries at that time, we reviewed the carrying value of intangible assets related to these reporting units, consisting primarily of acquired core technology.

As a result of this assessment, we concluded that the carrying value of goodwill related to EXFO Burleigh and the carrying value of intangible assets related to EXFO Burleigh and EXFO Photonic Solutions were impaired, and we recorded an impairment charge of \$4.5 million to write down goodwill and a pre-tax impairment charge of \$2.9 million to write down acquired core technology. Of the total impairment charge of \$7.4 million, \$6.9 million was related to EXFO Burleigh for goodwill and acquired core technology and \$555,000 was related to EXFO Photonic Solutions for acquired core technology.

The write-down of goodwill and acquired core technology of EXFO Burleigh was required, considering that we exited the optical component manufacturing automation business, whose revenue potential represented a long-term prospect. The write-down of acquired core technology from EXFO Photonic Solutions was required because revenue potential related to this long-lived asset was less than expected in the short and medium term due to the state of the market at the time.

However, no impairment of goodwill and intangible assets was required for EXFO Protocol since we believed that revenue potential from the protocol-layer testing market would remain strong in the short and medium term.

For the purposes of estimating fair value, we used a combination of discounted future cash flows and a market approach (sales multiples). The discounted future cash flows were estimated using periods ranging between eight and ten years, discount rates ranging between 15% and 20%, and an annual growth rate ranging between nil and 35%. The sales multiples used in the market approach ranged between 0.7 and 2.3. The assumptions used reflected our best estimates.

Fiscal 2004 and 2005

In fiscal 2004, we put one of our buildings located in Quebec City up for sale and received, at the beginning of fiscal 2005, a formal purchase offer for this building. Based on that offer, we concluded that the building was impaired and we recorded an impairment charge of \$620,000 in fiscal 2004, representing the excess of the carrying value of the building over its expected selling price. However, during the first quarter of fiscal 2005, some conditions of the formal offer were not met and the offer was declined. During fiscal 2005, we withdrew the building from the market. As at August 31, 2004, the building was not shown as a long-lived asset held for sale in the balance sheet because it was still used and, consequently, it was not available for immediate sale. This building reports to the Telecom Division.

In May 2004 and 2005, we performed our annual impairment test for goodwill and concluded that it was not impaired. Goodwill will be reviewed for impairment in May 2006, or prior if events or circumstances indicate it might be impaired.

Restructuring and Other Charges

Fiscal 2003

In fiscal 2003, we implemented a restructuring plan to align our cost structure with market conditions. Under that plan, we recorded charges of \$4.1 million, including \$2.8 million in severance expenses for the 172 employees who were terminated throughout the company, \$512,000 for impaired long-lived assets and \$855,000 for future payments on exited leased facilities located around the world. Our estimation of the fair value of such future payments took into account the estimated sublease rentals over the remaining terms of the exited leases.

Fiscal 2004 and 2005

In fiscal 2004, the Board of Directors approved a restructuring plan to consolidate the operations of our Life Sciences and Industrial Division, transferring EXFO Burleigh's operations mainly to EXFO Photonic Solutions facilities in Toronto. The consolidation process, which started in August 2004, was completed during fiscal 2005.

Overall, for that process, we incurred \$2.5 million in restructuring and other charges from which \$2.0 million were recorded in fiscal 2004 and the remaining of \$482,000 were recorded in fiscal 2005. The overall costs, which were recorded in the restructuring and other charges in the statements of earnings of the corresponding years, are detailed as follows: \$855,000 for severance expenses for the layoff of all employees of EXFO Burleigh; \$1.3 million mainly for the impairment of the EXFO Burleigh building; and the remaining \$399,000 for other expenses such as training and recruiting expenses and transfer of assets.

The EXFO Burleigh building was put up for sale in fiscal 2004, but it is not yet sold because of the difficult real estate market in Rochester, NY. The building is available for sale in its present condition and we expect to sell the property within the next twelve months. Consequently, in accordance with CICA handbook, section 3475, "Disposal of Long-Lived Assets and Discontinued Operations", it was shown in the balance sheet as a long-lived asset held for sale. The fair value used to determine the impairment loss of the building represents our best estimate of its selling price based upon the municipal valuation. Since September 1, 2004, the building is no longer amortized.

Finally, in fiscal 2005, we recorded adjustments of \$190,000 to the fiscal 2003 plan because actual charges, mainly for leased equipment, were lower than expected.

Our restructuring plans and cost-reduction measures represented our best efforts to respond to the difficult market conditions of the past years. Although we believe that such restructuring actions were appropriate and delivered the expected results, changes in market or industry conditions may lead us to incur additional restructuring actions and cost-reduction measures in the coming years.

Interest and Other Income

Our interest income mainly resulted from our short-term investments, less interests and bank charges. Interest and other income amounted to \$2.5 million, \$1.4 million and \$1.2 million for fiscal 2005, 2004 and 2003, respectively. The increase in interest income in fiscal 2005, compared to 2004, is due in part to the increase in our cash and short-term investments following our public offering in February 2004, the cash flows from operating activities and the increase in interest rates year-over-year. Also, in fiscal 2005, we recovered research and development tax credits earned in previous years and we were granted \$249,000 in interest by the tax authorities.

In fiscal 2004, we recorded one-time revenue of \$265,000 for the sale of non-core technologies. Without this revenue, interest and other income would have been relatively flat compared to 2003.

Assuming no acquisitions are made in fiscal 2006, we expect our interest income to increase during that fiscal year should interest rates increase and because our cash and short-term investments should increase with cash flows from operating activities.

Foreign Exchange Loss

Foreign exchange loss amounted to \$1.3 million, \$278,000 and \$1.6 million for fiscal 2005, 2004 and 2003, respectively.

Foreign exchange gains and losses are the result of the translation of operating activities denominated in currencies other than the Canadian dollar. The significant exchange loss recorded during fiscal 2005 is the result of the significant increase in the value of the Canadian dollar compared to the US dollar in fiscal 2005. For instance, the year-end exchange rate was Cdn\$1.3167 = US\$1.00 in fiscal 2004 compared to Cdn\$1.1889 = US\$1.00 in 2005, representing an increase of nearly 10% in the value of the Canadian dollar. The average exchange rate for fiscal 2005 was Cdn\$1.2315 = US\$1.00, compared to Cdn\$1.3300 = US\$1.00 in 2004.

During the same period last year, the Canadian dollar value remained relatively stable throughout the year, resulting in a slight exchange loss during that period. In addition, higher levels of activity in fiscal 2005, compared to 2004, further increased the foreign exchange loss in 2005.

It should be noted that additional foreign exchange rate fluctuations flow through the P&L line items as a significant portion of our operating elements are denominated in Canadian dollars and we report our results in US dollars.

We manage our exposure to currency risks with forward exchange contracts. In addition, some of our Canadian entities' operating activities are denominated in US dollars or other currencies, which further hedges this risk. However, a potential increase in the value of the Canadian dollar, compared to the US dollar, would have a negative impact on our operating results.

Income Taxes

Our income tax expense was \$2.6 million for fiscal 2005, compared to an income tax recovery of \$986,000 for 2004, and an income tax expense of \$15.1 million for 2003.

The income tax expense recorded in fiscal 2005 represents income taxes payable in some specific tax jurisdictions, mainly at the Canadian federal level. Income taxes payable at this specific level is reduced by research and development tax credits that are recorded against gross research and development expenses.

The income tax recovery recorded in fiscal 2004 is mainly due to the \$1.4 million unusual income tax recovery recorded during that year, offset in part by income taxes payable in some specific tax jurisdictions, mainly at the Canadian Federal level. The unusual tax recovery was due to the receipt, during that period, of income taxes paid in previous periods following the reception of a tax assessment.

Since fiscal 2003, we have been recording a full valuation allowance against our future income tax assets because it is more likely than not that these assets will not be recovered. The valuation allowance will be reversed once management will have concluded that realization of future income tax assets is more likely than not. Consequently, our income tax rates are distorted compared to statutory rates. Please refer to note 16 of our consolidated financial statements included elsewhere in this Annual Report for a full reconciliation of the income tax provision.

Liquidity and Capital Resources

Cash Requirements and Capital Resources

As at August 31, 2005, cash and short-term investments consisted of \$112.0 million, while our working capital was at \$135.3 million. Our cash and short-term investments increased \$22.9 million in fiscal 2005, compared to 2004, mainly due to the cash flows from operating activities of \$14.0 million as well as an unrealized foreign exchange gain of \$10.0 million on cash and short-term investments. However, this increase was partially offset by the cash payment of \$1.5 million for the purchase of property, plant and equipment as well as intangible assets. The unrealized foreign exchange gain resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was recorded in the cumulative translation adjustment in the balance sheet.

Our short-term investments consist of commercial paper issued by six high-credit quality corporations and trusts; therefore, we consider the risk of non-performance of these financial instruments to be remote. For the purposes of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. These short-term investments will be used for working capital and other general corporate purposes, including potential acquisitions.

We believe that our cash balances and short-term investments, combined with an available line of credit of \$5.8 million, will be sufficient to meet our liquidity and capital requirements for the foreseeable future. However, possible additional operating losses and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms. Our line of credit bears interest at prime rate.

The following table summarizes our commitments as at August 31, 2005:

Years ending August 31,	2006	2007	2008	2009	2010 and later	Total
Long-term debt	\$ 134,000	\$ 147,000	\$ 51,000	\$ -	\$ -	\$ 332,000
Operating leases	1,050,000	952,000	632,000	584,000	1,029,000	4,247,000
Total commitments	\$1,184,000	\$1,099,000	\$ 683,000	\$ 584,000	\$1,029,000	\$4,579,000

Sources and Uses of Cash

We finance our operations and meet our capital expenditure requirements mainly through cash flows from operating activities, the use of our cash and short-term investments as well as the issuance of subordinate voting shares.

In fiscal 2004, pursuant to a public offering in Canada, we issued 5.2 million subordinate voting shares for net proceeds of \$29.2 million (Cdn\$38.4 million) after deducting underwriting commissions of \$1.2 million (Cdn\$1.6 million). These net proceeds were recorded as short-term investments. Cash flows provided by financing activities in fiscal 2004 were attributable to the net proceeds of this offering.

Operating Activities

Cash flows provided by operating activities amounted to \$14.0 million in fiscal 2005, compared to \$751,000 in 2004 and \$5.6 million in 2003.

Cash flows provided by operating activities in fiscal 2005 were mainly attributable to the net earnings after items not affecting cash of \$9.1 million and the positive net change in non-cash operating items of \$4.9 million. This net change in non-cash operating items is mainly due to the decrease of \$6.1 million of our income taxes and tax credits recoverable following the collection, during the year, of income taxes and tax credits recoverable from previous periods. On the other hand, our accounts receivable increased by \$838,000 and our inventories increased by \$699,000. The increase of our accounts receivable is related to the increase in sales. Our inventories slightly increased despite the significant rise in sales due to tight inventory management.

Cash flows provided by operating activities in fiscal 2004 were mainly attributable to the net earnings after items not affecting cash of \$5.7 million, offset in part by the net increase of our non-cash operating items of \$4.9 million; that is, our accounts receivable increased by \$2.7 million, our income taxes and tax credits recoverable increased by \$2.5 million and our inventories decreased by \$1.0 million. The increase in our accounts receivable is directly related to the significant sales growth in fiscal 2004. The increase in our income taxes and tax credits recoverable is mainly due to the payment during the year of income taxes and to the recognition, during the year, of research and development tax credits not yet recovered. On the other hand, our increased sales level combined with tight inventory management enabled us to reduce our inventories overall.

We have delivered positive cash flows from operating activities for the last three fiscal years, despite the fact that we posted a net loss in each of these years.

Investing Activities

Cash flows used by investing activities totaled \$13.0 million in fiscal 2005, compared to \$29.7 million in 2004 and \$9.9 million in 2003.

In fiscal 2005, we acquired \$11.5 million worth of short-term investments with cash flows from operating activities and cash on-hand and paid \$1.5 million for the purchase of property, plant and equipment as well as intangible assets.

In fiscal 2004, we acquired \$28.6 million worth of short-term investments with the net proceeds of the public offering. In addition, we paid \$1.1 million for the purchase of property, plant and equipment as well as intangible assets.

Forward Exchange Contracts

We utilize forward exchange contracts to manage our foreign currency exposure. Our policy is not to utilize those derivative financial instruments for trading or speculative purposes.

Our forward exchange contracts, which are used to hedge anticipated US-dollar-denominated sales, qualify for hedge accounting; therefore, foreign exchange translation gains and losses on these contracts are recognized as an adjustment of the revenues when the corresponding hedged sales are recorded.

As at August 31, 2005, we held contracts to sell US dollars at various forward rates, which are summarized as follows:

Expiry dates	Contractual amounts	Weighted average contractual forward rates
September 2005 to August 2006	\$ 26,000,000	1.2630
September 2006 to November 2007	7,600,000	1.2500

As at August 31, 2005, the fair value of our forward exchange contracts, which represents the difference between their contractual amounts and their current trading value, amounted to an unrecognized gain of \$2.9 million.

Related-Party Transactions

In fiscal 2003, we acquired a building from a company owned by the President of EXFO for a cash consideration of \$930,000. This transaction was measured at the fair market value since it was not conducted during the normal course of operations, the change in ownership interest in the building was substantive and the fair market value was supported by independent appraisal.

In addition, for the years ended August 31, 2003 and 2004, we leased facilities from the company owned by the President of EXFO. The annual rental expense amounted to \$331,000 and nil, respectively. The rental expense for fiscal 2003 included \$234,000 for future

payments on an exited leased facility. As at August 31, 2004, restructuring charges payable included \$194,000 due to the company owned by the President of EXFO in connection with this exited leased facility. In September 2004, EXFO was released from its obligations under that lease, and it paid the full amount due to the related company. These rental expenses were measured at the fair market value since they were incurred during the normal course of operations.

Contingency

As discussed in note 12 to our consolidated financial statements included elsewhere in this Annual Report, EXFO was named as a defendant in a U.S. securities class action related to its initial public offering (IPO) in June 2000. The complaints allege that the prospectus and the registration statement for the IPO failed to disclose that the underwriters allegedly received excessive commissions and that the underwriters and some investors collaborated in order to inflate the price of EXFO's stock in the after-market.

In June 2003, a committee of EXFO's Board of Directors conditionally approved a proposed settlement between the issuer defendants, the individual defendants, and the plaintiffs. If approved, the settlement would provide, among other things, a release of EXFO and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. EXFO would

agree to undertake other responsibilities under the settlement, including agreeing to assign away, not assert, or release certain potential claims EXFO may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by EXFO's insurance carriers.

On June 25, 2004, the Plaintiffs moved for Preliminary Approval of the settlement. The court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the Notice Administrator for the settlement and ordered that the notice of the settlement be distributed to all settlement class members beginning on November 15, 2005, and completed by January 15, 2006. The settlement fairness hearing has been set for April 26, 2006. Following the hearing, if the court determines that the settlement is fair to the class members, the settlement will be approved. There can be no assurance that this proposed settlement would be approved and implemented in its current form, or at all. Therefore, it is not possible to predict the final outcome of the case, nor determine the amount of any possible losses. If the settlement process fails, EXFO will continue to defend its position in this litigation that the claims against it, and its officers, are without merit. Accordingly, no provision for this case has been made in the consolidated financial statements as at August 31, 2005.

Share Capital and Stock-Based Compensation Plans

Share Capital

As at November 3, 2005, EXFO had 37,900,000 multiple voting shares outstanding, entitling to ten votes each, and 30,674,617 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

Long-Term Incentive Plan

In January 2005, EXFO made certain amendments to the existing Stock Option Plan, including the renaming of the plan to Long-Term Incentive Plan, which now includes restricted share units (RSUs) in addition to stock options. RSUs are "phantom" shares that rise and fall in value based on the value of EXFO's subordinate voting shares and are redeemable for actual subordinate voting shares or cash, at the discretion of the Board of Directors, on the vesting dates established by the Board of Directors at the time of grant. The vesting dates are subject to a minimum of three years and a maximum of ten years from the award date. RSUs granted under the plan expire at the latest ten years from the date of grant.

Deferred Share Unit Plan

In January 2005, EXFO established a Deferred Share Unit (DSU) Plan for the members of the Board of Directors as part of their annual retainer fees. Each DSU entitles the Board members to receive one subordinate voting share. DSUs are acquired on the date of grant and will be redeemed in subordinate voting shares when the Board member will cease to act as Director of EXFO.

The aggregate number of subordinate voting shares covered by stock options, RSUs and DSUs granted under the Long-Term Incentive Plan and the Deferred Share Unit Plan was 2,963,678 as at August 31, 2005. The maximum number of subordinate voting shares issuable under these two plans cannot exceed 6,306,153 shares. The following tables summarize information about stock options, RSUs and DSUs granted to the members of the Board of Directors and to Management and Corporate Officers of the company and its subsidiaries as at August 31, 2005:

Stock Options	Number	% of issued and outstanding	Weighted average exercise price
Chairman of the Board, President and CEO (one individual)	168,424	6%	\$ 9.34
Board of Directors (five individuals)	194,375	7%	\$ 6.23
Management and Corporate Officers (nine individuals)	340,091	12%	\$ 14.39
	702,890	25%	\$ 10.92

Restricted Share Units	Number	% of issued and outstanding
Chairman of the Board, President and CEO (one individual)	13,089	7%
Management and Corporate Officers (nine individuals)	151,096	86%
	164,185	93%
<hr/>		
Deferred Share Units	Number	% of issued and outstanding
Board of Directors (five individuals)	23,734	100%

Off-Balance Sheet Arrangements

As of August 31, 2005, our off-balance sheet arrangements consisted of forward exchange contracts, which are described in details in note 18 to our consolidated financial statements, included elsewhere in this Annual Report.

Variable Interest Entity

As of August 31, 2005, we did not have significant interests in any variable interest entities.

Risks and Uncertainties

Over the past few years, we have managed our business in a difficult environment; focused on research and development programs for new and innovative products aimed at expected growth pockets in our sector; continued the development of our domestic and international markets; and made strategic acquisitions. However, we operate in a highly competitive sector that is in constant evolution and, as a result, we encounter various risks and uncertainties that must be given appropriate consideration in our strategic management policies.

Firstly, we are exposed to currency risks due to the export of our Canadian-manufactured products, the large majority of which are denominated in US dollars. These risks are partially hedged by operating expenses denominated in US dollars, the purchase of raw materials in US dollars and forward exchange contracts. The increased strength of the Canadian dollar, compared to the US dollar, over the last two years caused our operating expenses, as well as our foreign exchange loss, to increase. Any further increase in the value of the Canadian dollar in the coming months will negatively affect our results of operations.

Secondly, during the last few quarters, we experienced unusual sales concentration with a U.S.-based Tier-1 telecom carrier. Although we believe this sales concentration is largely due to our leadership position in the FTTx test market, orders from this customer can fluctuate in upcoming quarters, depending on the carrier's deployment needs, products requirements and schedule.

In addition, risks and uncertainties related to the telecommunications test and measurement industry involve the rapid development of new products that may have short life cycles and require extensive research and development; the difficulty of adequately predicting market size and trends; the difficulty of retaining highly skilled employees; and the ability to quickly adapt our cost structure to changing market conditions in order to achieve profitability.

Furthermore, given our strategic goals for growth and competitive positioning in our industry, we are continuously expanding into international markets. This exposes us to certain risks and uncertainties related to changes in local laws and regulations, multiple technological standards, protective legislation and pricing pressure.

Also, while strategic acquisitions, like those we have made in the past and possibly others in the future, are essential to our long-term growth, they also expose us to certain risks and uncertainties related to the rapid and effective integration of these businesses as well as their products, technologies and personnel.

The economic environment of our industry could also result in some of our customers experiencing difficulties and, consequently, this could have a negative effect on our results especially in terms of future sales and recoverability of accounts receivable. However, the sectorial and geographic diversity of our customer base provides us with a reasonable level of protection in this area. Finally, other financial instruments, which potentially subject us to credit risks, consist mainly of cash, short-term investments and forward exchange contracts. Our short-term investments consist of debt instruments issued by six high-credit quality corporations and trusts. Our cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, we consider the risk of non-performance on these instruments to be remote.

For a more complete understanding of risk factors that may affect us, please refer to the risk factors set forth in our disclosure documents published with securities commissions at www.sedar.com in Canada or www.edgar.com in the U.S.

Quarterly Summary Financial Information (unaudited)

(tabular amounts in thousands of US dollars, except per share data)

	1st quarter	2nd quarter	3rd quarter	4th quarter	Years ended August 31,
2005					
Sales	\$ 21,597	\$ 23,135	\$ 26,180	\$ 26,304	\$ 97,216
Cost of sales	\$ 10,225	\$ 10,431	\$ 11,478	\$ 11,925	\$ 44,059
Gross margin	\$ 11,372	\$ 12,704	\$ 14,702	\$ 14,379	\$ 53,157
Earnings (loss) from operations	\$ (1,337)	\$ (182)	\$ 509	\$ 811	\$ (199)
Net earnings (loss)	\$ (2,373)	\$ 9	\$ 276	\$ 454	\$ (1,634)
Basic and diluted net earnings (loss) per share	\$ (0.03)	\$ —	\$ —	\$ 0.01	\$ (0.02)
2004					
Sales	\$ 15,962	\$ 16,880	\$ 20,456	\$ 21,332	\$ 74,630
Cost of sales	\$ 7,815	\$ 7,528	\$ 9,637	\$ 9,576	\$ 34,556
Gross margin	\$ 8,147	\$ 9,352	\$ 10,819	\$ 11,756	\$ 40,074
Loss from operations	\$ (3,145)	\$ (3,485)	\$ (1,888)	\$ (2,052)	\$ (10,570)
Net loss	\$ (2,008)	\$ (2,885)	\$ (1,188)	\$ (2,343)	\$ (8,424)
Basic and diluted net loss per share ⁽¹⁾	\$ (0.03)	\$ (0.04)	\$ (0.02)	\$ (0.03)	\$ (0.13)
2003					
Sales	\$ 17,748	\$ 14,753	\$ 15,103	\$ 14,326	\$ 61,930
Cost of sales	\$ 8,031	\$ 7,939	\$ 10,460	\$ 9,767	\$ 36,197
Gross margin	\$ 9,717	\$ 6,814	\$ 4,643	\$ 4,559	\$ 25,733
Loss from operations	\$ (3,562)	\$ (6,085)	\$ (18,924)	\$ (11,013)	\$ (39,584)
Net loss	\$ (2,158)	\$ (4,246)	\$ (38,427)	\$ (10,119)	\$ (54,950)
Basic and diluted net loss per share	\$ (0.03)	\$ (0.07)	\$ (0.61)	\$ (0.16)	\$ (0.87)

(1) Per share data is calculated independently for each of the quarters presented. Therefore, the sum of this quarterly information does not equal the corresponding annual information.

Fourth-Quarter Results

In the fourth quarter of fiscal 2005, global sales were \$26.3 million, compared to \$21.3 million for the same period last year. In fiscal 2005, we benefited from an increased demand for our test solutions following the deployment of fiber deeper into access networks (FTTx). We also consolidated our leadership position in the FTTx test market by recognizing significant revenue from two leading U.S. carriers deploying fiber in their access networks. In addition, the positive spending environment in the telecommunications industry helped us increase our sales in 2005. Finally, we gained market share in the fluorescence illumination market as well as increased our sales in the curing market year-over-year.

In the fourth quarter of fiscal 2005, gross margin amounted to 54.7% of global sales, compared to 55.1% for the same period last year. Despite the significant increase in sales year-over-year (23.3%), gross margin decreased 40 basis points due to aggressive pricing pressure in fiscal 2005, a different customer mix and the increase in the strength of the Canadian dollar compared to the US dollar, year-over-year.

In the fourth quarter of fiscal 2005, earnings from operations were \$811,000, compared to a loss from operations of \$2.1 million for the same period last year. Net earnings amounted to \$454,000, or \$0.01 per diluted share in the fourth quarter of fiscal 2005, compared to a net loss of \$2.3 million, or \$0.03 per diluted share for the same period last year.